January 30, 2020

Dear Commissioners and Commission Staff:

Thank you for the opportunity to submit comments regarding the Chicago Mercantile Exchange's (CME) Request for Approval: Amendments to Increase the Initial Spot Month Position Limit of the Live Cattle Futures Contract (submitted January 7, 2020).

This amendment filing does not address significant current issues with the Live Cattle Contract. Further, it risks exacerbating current problems. I am opposed to CFTC approving the amendment filing.

The most important aspect for any futures contract is the quality of futures-to-cash convergence during spot month expiration. CME added and replaced lost stockyard delivery capacity with the goal of improving convergence. A quantitative evaluation of convergence quality, since the capacity changes, should be a prerequisite to this amendment. CME has either not conducted this evaluation or not shared it with market participants. This lack of systematic evaluation is concerning.

To date, these changes have not improved convergence. Quantitative evaluations indicate that spot month convergence has declined rapidly, in recent years. On average in 2019, actual spot month convergence diverged $2.14/cwt from expected delivery equivalent convergence. In 2016 (prior to delivery capacity changes), actual versus expected convergence was $0.33/cwt. Until poor convergence is diagnosed and corrected, further spot month amendments are imprudent.

Why has convergence deteriorated despite delivery capacity additions? Simply, increased capacity does not equate to increased deliverable supply.

Satisfying "regulatory definitions" of deliverable supply, as they relate to spot-month position limits, is irrelevant when futures empirically do not converge to cash. Nevertheless, CME argues that expanded deliverable capacity and the amended spot month speculative limit satisfy CFTC Regulation 150.5(b)(1): *"For physical delivery contracts, the spot month limit level must be no greater than one-quarter of the estimated spot month deliverable supply…"* The amendment filing improperly relies upon stockyard capacity to define "*estimated spot month deliverable supply*".

The correct and relevant definition for spot month deliverable supply is <u>economic deliverable supply</u>. According to the CFTC, <u>economic deliverable supply</u> is *"that portion of the deliverable supply of a commodity that is in position for delivery against a futures contract, and is not otherwise unavailable for delivery".* Estimating <u>economic deliverable supply</u> is difficult. Recent spot month observations can serve as proxy estimates. Despite frequent and apparent economic incentives, recent delivery issuances have been minimal and sporadic. Something other than deliverable capacity is causing cash cattle to be *"otherwise unavailable for delivery".*

Numerous obstacles restrict <u>economic deliverable supply</u>. The most significant obstacle is the economic value generated by continued feeding of cattle that are acceptable by the narrow futures' live delivery specifications. It is important that live delivery specifications ensure that delivered cattle <u>can</u> continue feeding. However, specifications must not narrowly restrict delivery to only animals that have a riskless, immediate economic return to continued feeding. Unfortunately, in CME's quest to ensure cattle <u>can</u> continue feeding, current specifications can only be satisfied by partially finished feeder steers and heifers. This specification error results in cash/futures divergence because the potential issuer, acting in his own best financial interest, does not issue cattle and alternatively continues feeding at his own economic gain. It should not be surprising that few deliveries are issued despite frequent, apparent incentives to deliver. The futures contract is a heavy feeder cattle equivalent. This problem is the most significant diagnosis for infrequent delivery issuance and persistent poor convergence. Simply, the economic deliverable supply is substantially smaller than the CME contends.

I urge the CFTC to not approve the amendment filing. It is imperative that CME first fix existing convergence issues prior to enacting amendments that may or may not affect future convergence. To enact this amendment now would, at the least, complicate the future analysis of its resulting impacts. At the worst, enacting this amendment could further inhibit spot month convergence.

My goal in commenting is to improve the contract and make it more reflective of the cash market. I believe achieving that goal will greatly benefit the entire cattle industry and the CME, for the long term. Thank you for the comment opportunity and for your careful consideration of these comments.

Sincerely,

Joe Kovanda
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